

# FC&S LEGAL

## The Insurance Coverage Law Information Center

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### LIABILITY INSURANCE BASICS FOR LITIGATORS

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Most disputes carry insurance implications. Liability insurance can be an important resource, as the insurer may have a duty to defend or reimburse the defendant company's or individual's defense costs. The insurer also may have a duty to indemnify the defendant for judgments and settlements.

There may be other intangible benefits of insurer participation, such as the insurer's experience assisting in the defense of similar claims, and the plaintiff's perception that insurance (and not the client's assets) is the primary target in the litigation.

This article identifies and describes briefly the insurance issues most likely to arise when defending against a claim or lawsuit. These are general considerations that always should be confirmed by reviewing the insurance policies at issue and applicable law, with the resulting course of action tailored to your particular circumstances.

#### Topic Outline

- **Potentially Relevant Policies**
- **"Claims Made" or "Occurrence" Coverage**
- **Notice Obligations**
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  - *Occurrence or Circumstances That May Give Rise to a Claim in the Future*
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- **"Duty to Defend" v. Defense "Reimbursement"**
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- **Insurer Denial of Coverage**

#### Potentially Relevant Policies

Determine which policies potentially are relevant based upon the subject matter of the underlying dispute. Key liability insurance lines, along with examples of typical claims under each, are as follows:

- **General Liability:** Claims alleging bodily injury, property damage, or personal injury torts such as defamation and invasion of privacy.

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- **Directors and Officers (“D&O”) Liability:** Claims alleging management liability for financial losses. In general, “Side A” insures directors and officers against claims not indemnified by the company; “Side B” reimburses the company for indemnified claims against the directors and officers; and “Side C” insures the company against certain claims asserted directly against the company.
  - **Errors and Omissions (“E&O”) Liability:** Claims alleging losses stemming from professional services to customers or clients. Generally speaking, professional services are services that require a license (e.g., medicine, law, or engineering) or require specialized knowledge, education or training.
  - **Fiduciary Liability:** Claims alleging financial losses due to ERISA violations and certain other pension- and benefit-related acts or omissions.
  - **Employer Liability:** Claims alleging employee bodily injury or wrongful death that are not barred by the applicable workers’ compensation statute.
  - **Employment Practices Liability:** Claims by employees alleging other workplace violations such as wrongful termination, harassment, discrimination, retaliation, etc.
  - **Crime/Fidelity:** Claims alleging employee theft of company assets or third party assets in the custody of the company.
  - **Other Specialty Coverages:** Claims alleging other “niche” and emerging-risk liabilities, such as environmental, cyber liability, sexual misconduct and representations and warranties.

Each policy available to the defendant should be reviewed carefully by insurance advisors to determine its potential applicability to the underlying dispute.

### “Claims Made” or “Occurrence” Coverage

Whether a policy responds to the underlying claim also depends upon whether the insurance is afforded on an “occurrence” or “claims made” basis.

- **“Occurrence” Policies:** Insure against bodily injury or property damage that happens during the policy period. It is irrelevant when the liability claim actually is asserted against the insured.
- **“Claims Made” Policies:** Insure against liability arising from a claim (typically a lawsuit, written demand for damages, or governmental investigation) that is first asserted against the insured during the policy period. Most claims made policies do not require the insured’s alleged wrongful acts, the injury- or damage-causing event, or the alleged financial losses to happen during the policy period. However, such policies often require that event to have occurred after a specific date (sometimes called the “retroactive date”), which may coincide with when the insurance company began insuring the client, or when the client first purchased the particular line of coverage and maintained it continuously.

### Notice Obligations

No matter what line of liability insurance, the policy will impose notice obligations on the insured. Timely notice is a condition precedent to coverage.

Notice requirements differ depending upon whether the insured: a) has been sued or has received some other formal demand; or b) has not yet been sued or received a formal demand but is aware of an occurrence or circumstances that may give rise to a claim.

#### Suit or Formal Demand

- **“Claims Made” Policies:** Notice of claim typically is required “as soon as practicable” but no later than 30 to 90 days after policy expiration. Failure to comply may defeat coverage even if the insurer is not prejudiced by the delay.
- **“Occurrence” Policies:** Notice of suit typically is required “immediately.” There often is no express deadline but delay should be avoided, especially when the policy includes a duty to defend the client. In most (but not all) jurisdictions an insurer that denies a claim due to late notice must show that the delay prejudiced its interests.

#### Occurrence or Circumstances That May Give Rise to a Claim in the Future

- **“Claims Made” Policies:** The insured may provide “notice of circumstances” that could give rise to a claim in the future. This preserves coverage for the future claim under the present policy, even if the claim ultimately is asserted after the

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policy expires. Providing notice of circumstances is at the insured's discretion, and not doing so typically will not jeopardize coverage under the policy in effect when a claim eventually is received.

- **"Occurrence" Policies:** Notice of an occurrence which may result in a claim typically is required "as soon as practicable." "Occurrence" often is defined as "an accident including continuous exposure to substantially the same general harmful conditions." Failure to give notice of an occurrence may jeopardize coverage if the insurer is prejudiced by a delay or lack of notice.

### Other Notice Considerations

- **Primary v. Excess Policies:** The primary insurer(s) should receive notice of every potentially covered claim. An excess insurer should be notified if the claim is likely to implicate insurance above the primary layer; the prudent course is to notify excess insurers contemporaneously with the primary insurer, often by simply copying them on the written notice to the primary insurer.
- **Pre-Notice Defense Costs:** Even if notice is timely, defense costs incurred prior to notice typically are not reimbursable.
- **Bottom Line:** There generally is no harm in providing notice under all potentially relevant policies, so absent unique business circumstances insureds should act promptly to avoid the risks of untimely notice.

### "Duty to Defend" v. Defense "Reimbursement"

The role of insurance in the conduct and funding of the defense depends upon which type of defense coverage is afforded by the policy. The policy's "insuring agreement" likely will set forth one of two defense obligations:

- **Duty to Defend:** An insurer subject to a duty to defend has the right and duty to control the defense, which includes choosing, directing, and paying defense counsel, investigating the claim, and negotiating a settlement. The insurer must pay for all reasonable defense costs and conduct the defense in accordance with its duty of good faith and fair dealing toward the policyholder. The actual language of the policy controls, but defense costs are usually paid in addition to the stated limit of the policy.
- **Defense Reimbursement:** The insurer has only a duty to pay defense costs, and the insured selects counsel and controls the defense. The insurer's consent must be obtained prior to incurring defense expenses or settling the case, but such consent shall not be unreasonably withheld. Defense costs are within the stated limit of the policy, so amounts paid "exhaust" the policy limit.

### Defending the Case: "Duty to Defend" Policy

- **Establishing the Duty:** The insurer must defend the insured if any part of the underlying claims could potentially be covered, even if demonstrably groundless, false or fraudulent. The potential for coverage generally is determined by application of the "eight corners" rule, which requires comparison of the complaint and insurance policy. Once established, the duty to defend generally continues until there no longer is the potential for coverage of any claims asserted in the case (*i.e.*, when the only potentially covered cause of action is dismissed), or until the case concludes by settlement, judgment, or final determination by appeal.
- **Choice of Law:** Insurance policies usually do not have choice-of-law provisions. The law that applies to an insurance coverage claim may not be the same law that applies to the claims against the insured; Instead,, the law of state in which a policy is delivered to the first named insured may apply to coverage issues arising under that policy. Review the relevant jurisdiction's choice of law principles.
- **Duty to Defend Is Indivisible:** An insurer's duty to defend generally extends to all claims alleged in a complaint, even if not all causes of action have the potential for coverage.
- **Reservation of Rights:** As discussed more fully below, if an insurer accepts its duty to defend while reserving the right to assert one or more defenses to coverage, most jurisdictions recognize that a potential conflict of interest exists between insurer and policyholder. If an actual conflict exists, the insurer is entitled to "independent counsel."
- **Deductible or Self-Insured Retention:** These two mechanisms operate differently under a duty to defend policy. An insurer generally must provide a defense immediately if the policy contains a deductible, but the insurer is permitted to seek payment of the deductible once the representation concludes. However, if the policy has a self-insured retention, the defense obligation remains with the insured until that retention is satisfied by the payment of defense costs that otherwise would be covered.

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- **Cooperation of Insured:** Most policies contain a “cooperation clause” that requires the insured to provide the insurer with requested information and to attend hearings, depositions and trial as necessary. Failure to cooperate that prejudices the insurer can support a denial of coverage, although most states impose a heavy burden on the insurer to establish conduct constituting a failure to cooperate.

### Defending the Case: “Reimbursement” Policy

- **Establishing the Duty:** The insurer generally must reimburse defense costs whenever the potential for coverage exists, as determined by application of the “eight corners” rule. A minority of courts, however, have found the duty to reimburse defense costs is narrower than the duty to defend, and therefore the insured must demonstrate that claims are within the basic scope of coverage before obtaining reimbursement.

- **Insured Selection of Defense Counsel:** The insured typically has the right to select defense counsel subject to the insurer’s reasonable consent, although some policies require that the firm be selected from a pre-approved list (i.e., “panel counsel”).

- **Defense Counsel Billing Rates:** Hourly rates must be “reasonable” under applicable common law or statute, and may be subject to negotiation. Relevant factors in determining reasonableness often include counsel’s subject-matter expertise, the type of case, the amount of the insured’s exposure, and the customary fee charged for similar services in the geographic area. The insurer will often provide defense counsel with billing guidelines and review each invoice to identify purportedly unreasonable or unnecessary expenditures.

- **Timing of Reimbursement:** The timing of reimbursement is governed by the policy language, which may specify a number of days or months within which invoices must be paid. Absent express policy language, courts typically require an insurer to “advance” defense costs “on a current basis,” meaning on a rolling basis before the underlying matter is resolved. A minority of jurisdictions continues to hold that “reimbursement” requires payment only at the conclusion of the matter.

- **Deductible or Self-Insured Retention:** These terms generally are interchangeable when determining the timing of payments under a reimbursement policy, and either must be satisfied before defense costs are reimbursed.

- **Insurer Right to Associate:** The insurer has the “right to associate” in the defense. In practical terms, this is the right to be informed of case developments, consult on strategy, hire its own counsel to monitor the litigation, and consent to defense expenditures and settlements, such consent not to be withheld unreasonably.

- **Allocation:** Where the insured incurs costs to defend both covered and uncovered claims, the insurer is required to reimburse only the former. Some policies impose a particular allocation methodology; in the absence of such a provision, most courts apply a “reasonably related” test, where so long as an expense is reasonably related to the defense of a covered claim, it is apportioned wholly to the covered claim.

### Defending the Case: General Considerations Under All Policies

- **Covered Defense Costs:** These include attorneys’ fees and expenses, expert witness and investigators’ fees, etc. But the insurer has no duty to pay the insured’s internal costs, such as employee compensation, benefits, and corporate time and expense in responding to litigation, and no duty to fund the insured’s affirmative claims, including cross-claims or counterclaims in the same action that the insurer is defending.

- **Reporting:** It is prudent to report significant developments in the litigation to the insurer, so that the insurer understands the merits and procedural posture of the case and has sufficient information to process defense payments and consent to any settlement.

- **Insurer Litigation Guidelines:** The insurer’s billing and case-handling guidelines should be obtained and followed to the extent reasonably possible. Procedures that appear out of step with complex litigation or otherwise problematic should be discussed with the insurer before significant fees and expenses are incurred.

- **Privilege:** Defense-related communications between counsel that is defending or managing the claim and an insurer that has acknowledged its duty to defend or reimburse defense costs generally retain their privileged status under the common interest doctrine, even if the insurer accepted the defense under a reservation of rights, but check the law of the relevant jurisdiction.

- **Multiple Insured Defendants:** The insurer may retain one counsel to represent multiple insureds with common interests, subject to applicable ethical rules. In general, separate counsel must be retained if there is, or is likely to be, any conflict

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between insureds in the litigation, either directly or through a litigation position taken to alleviate their respective liability.

- **Role of Indemnity Agreements:** The insured also may have the right to defense and indemnification for the dispute under contracts entered into in the course of its business. The insured should preserve these contractual rights (by complying with notice requirements, etc.) and pursue them to the extent the insured is not made whole by insurance.
- **Disclosure of Insurance in Litigation:** Potentially applicable policies should be produced under federal initial disclosure requirements, or in response to direct discovery requests.

### Insurer Reservation of Rights

An insurer can respond to a claim in one of three ways. It can accept and agree to cover the claim. It can deny coverage and disclaim all obligations to the insured. Or it can accept the defense while reserving its rights to deny coverage eventually because coverage may not exist for all or part of the claim.

A reservation of rights creates potential adversity between the insurer and insured and may have consequences for how the insurer handles the defense.

- **Must Raise All Defenses:** Unless the insurer is an excess insurer with no duty to defend, as a general rule a defending insurer is estopped from relying on a coverage defense of which it had notice but did not raise in a reservation of rights communication.
- **Duty to Provide Complete Defense:** If the policy contains a duty to defend, the insurer must provide the insured a complete defense notwithstanding the reservation of rights; the insurer cannot refuse to defend against claims for which coverage may not exist. But the defense under a reimbursement policy may be subject to allocation.
- **Reservation as Conflict:** A reservation of rights does not always create a conflict of interest affecting the insurer's control of the policyholder's defense. A ground for reservation may not implicate the manner in which the policyholder is defended. For example, an insurer may reserve on the basis of a policy exclusion for punitive damages sought against the policyholder. Such an exclusion will apply regardless of how the policyholder is defended: no conflict of interest exists. If, however, for example, the insurer reserves on the basis of an exclusion for intentional conduct, a conflict of interest exists because the insurer could defend against the claim in a way that makes it more likely that intentional conduct is found.
- **Control of Defense:** When the reservation creates a conflict under a duty to defend policy, an insurer loses the right to control the insured's defense. Different jurisdictions approach this issue differently. One approach is to transfer complete control to the insured, giving the insured an unfettered right to choose its counsel. A second approach is to allow the insured to select its own counsel, subject to the approval of the insurer, which cannot be unreasonably withheld. A third approach is to require the insurer to retain independent counsel for the insured, which the insurer does not control.
- **Insurer Payment of Defense Costs:** Under any approach, the insurer must pay the reasonable legal fees of insured-selected counsel. Unless a statute or clear policy language allows it, the rates the insurer normally pays for panel counsel are not the standard of reasonableness.
- **Insurer Recoupment of Defense Costs:** If the case against the insured develops such that no coverage exists, an issue arises as to whether the insurer can recoup previously paid defense costs. Some jurisdictions permit such recoupment, especially when addressed in a reservation of rights. Other jurisdictions, however, do not allow recoupment unless the policy allows it expressly. Reimbursement policies usually do; duty to defend policies do not. Insurers bear the burden of proof on this issue.

### Settlement of the Underlying Claim

Insurers generally have a right to consent to the settlement of any underlying claim for which the insured seeks coverage.

#### Duty to Defend Policy

- **Insurer Consent:** In a duty to defend policy, the right of consent stems from the insurer's right and duty to defend the insured, the cooperation clause, and the prohibition against "voluntary payments" by the insured. Even where the insurer has relinquished control of the defense due to a reservation of rights, its consent must be obtained for any settlement that will be funded by insurance.

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- **Insurer Duty to Settle:** While the specific standard of conduct varies by jurisdiction, an insurer must act reasonably when determining whether to settle. Failure to do so may expose the insurer to extra-contractual damages. But the insurer is under no absolute duty to settle just because the insured's liability exposure exceeds the policy limit.

### Reimbursement Policy

- **Insurer Consent:** The insurer usually has the express right to consent to any settlement, such consent not to be withheld unreasonably.

- **Settlement Hammer:** Most policies contain a settlement "hammer" provision, whereby coverage is reduced if the insured rejects a settlement advocated by the insurer.

- **Order of Payments:** The "order of payments" provision (a typical feature in D&O policies) states that if loss exceeds the policy limit, the insurer must pay the insured individuals' non-indemnified liability before satisfying that of the company.

### General Considerations Under All Policies

- **Settlement Dynamics:** The primary insurer should receive prior notice of all settlement-related activities, such as mediation, settlement conferences with courts, and settlement negotiations. The appropriate level of insurer involvement will depend on the circumstances of the matter.

- **Role of Excess Insurance:** Excess insurers typically have no duty to contribute to a settlement until the primary limits are exhausted. But if any settlement or judgment is likely to exceed the primary limits, the excess insurer should be kept informed of case developments and negotiations.

- **What Damages Are Not Covered:** Typically, fines and penalties are not covered. Damages attributable to breach of contract and intentional torts also typically are not covered, unless they can be attributed to other, covered claims against the insured. Coverage for punitive, multiplied or exemplary damages varies by jurisdiction.

- **Allocation:** When a settlement or judgment resolves both covered and uncovered claims, the insurer is required to pay only the former. Allocation of judgments and settlements is an inexact science, and rarely is predetermined by the policy. Courts have applied various tests, including the "larger settlement rule," whereby a loss is covered up to the amount where uncovered claims make the loss larger; and the "relative exposure" rule, which allocates according to the degree to which the respective claims or parties contributed to the loss. Accordingly, settlement documents should be reviewed for any impact they may have on allocation and resulting insurance recovery. Where possible, the policyholder and its insurer(s) should agree on allocation before entry of a settlement.

### Insurer Denial of Coverage

Denial of coverage (and therefore denial of the duty to defend or reimburse defense costs) is warranted when there is no possibility of coverage for the underlying claim.

- **Burden of Proof:** The insurer's determination must be based on an analysis of the policy and the document setting forth the claim, usually a complaint or similar pleading. No extrinsic evidence can be considered in most circumstances. The question to be answered is: If the allegations against the policyholder are true, could coverage exist? If the answer is, "Yes," then the insurer has a duty to defend or reimburse. If the answer is, "No," then denial of coverage is justified.

- **Potential Consequences:** Denying coverage carries certain risks for insurers *if* they are found to have breached the duty to defend. *First*, in some jurisdictions, a breach of the duty to defend carries the added penalty of forfeiting coverage defenses on indemnity. *Second*, if the refusal to defend was not in good faith, the insurer exposes itself to extra-contractual damages.

- **Informal Dispute of Denial:** If the insured believes the insurer incorrectly denied coverage, the insured should respond with facts and argument supporting the claim. The insured's insurance broker also may have a well-established relationship with the insurer and can assist in these communications. This "back and forth" process often can resolve (or at least narrow) a dispute before incurring the expense and risks of coverage litigation.

- **"Pay and Chase":** If an allegedly incorrect coverage denial persists, the insured may choose to fund its own defense and resolution of the underlying claim, then seek reimbursement in a later coverage action. This avoids a costly and potentially damaging "two front war" of litigating simultaneously the underlying claim and the coverage dispute.

- **Litigation/Arbitration:** Alternatively, the insured may not want to delay resolution of the coverage dispute. If the insured files immediately a lawsuit or arbitration demand solely for breach of the duty to defend, the insurance dispute may be limited to the interpretation of the policy and complaint, with little overlap with the disputed facts at issue in the underlying claim. In addition, an insurer may file its own action to declare its obligations, if any, under an insurance policy. In some states, such an action will be stayed or dismissed if it prejudices the insured's ongoing defense of the underlying claim.

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